

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
PHILIP L. AND) No. 82A-924-KP
MADELEINE G. **LAWTON**)

For Appellants: Richard W. Konig
Attorney at Law

For Respondent: Elleene **K.** Tessier
Cdunsel

O P I N I O N

This appeal is made pursuant to section **185931**/
of the Revenue and Taxation Code from the action of the
Franchise Tax Board on the protest of Philip **L.** and
Madeleine G. **Lawton** against a proposed assessment of
additional personal income tax in the amount of **\$1,931.52**
for the year 1979.

1/ Unless otherwise specified, all **section** references
are to sections of the Revenue and Taxation Code as in
effect for the year in issue.

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The issue presented by this appeal is whether appellants are entitled to deduct legal expenses they incurred in resisting an eminent domain action instituted by the City of Stockton.

Appellants are husband and wife. Prior to the appeal **year**, Mrs. **Lawton** owned a one-half interest in a parcel of real property in downtown Stockton. Apparently, Mrs. **Lawton** received rent proceeds from the movie theater located on that property. In 1973, **the City** of Stockton commenced eminent domain proceedings to acquire the property. Allegedly, the condemnation action **was** initiated for the benefit of a third-party developer. Mrs. **Lawton** filed suit against the city challenging the condemnation proceedings on the ground that the taking of her property had no public purpose. Mrs. **Lawton** prevailed and the court ordered the city to terminate its **condemnation proceedings** in 1979,

Appellants deducted the legal expenses incurred in their battle with the City of Stockton to defeat the eminent domain action on their joint tax return they filed for 1979. Respondent audited that return and disallowed the **deduction on** the ground that the cost of defending or perfecting title to property is a nondeductible capital **expenditure** which must be added to the basis **of the** property. An appropriate assessment was issued. Appellants protested stating **that their action against the city** was not one in which title was defended, since the title to the property was undisputed. Respondent denied the protest and this appeal followed.

As respondent concedes the deductibility of the fees in all other respects, the only issue on appeal is whether the fees are capital expenditures or current expenses. Section 17202. provides for the deduction of **all** ordinary and necessary expenses paid or incurred during the taxable year **in carrying on a trade or business**. **Similar provision is made** in section 17252 for the deduction of all ordinary and necessary expenses paid or incurred during the taxable year for the management, conservation, or maintenance of property **held** for the production of income, Section **17283** prohibits the deduction of capital expenditures as current expenses. Sections 17202, 17252, and 17283 are virtually identical to, and were based upon, sections **162**, 212, and 263, respectively; of the Internal Revenue Code. Therefore, federal cases interpreting the federal statutes are highly persuasive as to the interpretation of the

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respective state statutes. (Andrews v. Franchise Tax Board, 275 **Cal.App.2d** 653 [**80 Cal.Rptr. 403**] (1969).)

In an effort to develop a uniform approach to decide the deductibility of expenses, the United States Supreme Court in United States v. Gilmore, 372 U.S. 39 [**9 L.Ed.2d 570**] (1963), formulated the so-called "origin and character" test. As stated by the court, the characterization of **the expense**:

[D]epends on whether or not the claim arises in connection with the taxpayer's **profit-seeking activities**. It does not **depend on** the consequences that might result to a taxpayer's income-producing property from a failure to defeat the claim . . . **[S]uch** a rule [based upon consequences to the taxpayer! would **lead** to capricious results. If two taxpayers are each sued for an automobile accident while driving for pleasure, deductibility of their litigation costs would turn on the mere circumstances of the character of the assets each happened to possess, that is, whether the judgments against them stood to be satisfied out of income- or nonincome-producing property. We should be slow to attribute to Congress a purpose producing such unequal treatment among taxpayers, resting on no rational foundation.

* * *

For these reasons, we **resolve** the conflict among the lower courts- . . . in favor of the view that the origin and character **of** the claim with respect to which an expense was incurred, rather than its potential **consequences** upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was . . . deductible or not
(Emphasis original.)

(United States v. Gilmore, supra, 372 U.S. at 48-49.)

The United States Court of Appeals extended the application of the "origin and **character**" standard to the question of capital vs. noncapital expenses in Madden v. Commissioner, 514 **F.2d** 1149 (9th Cir. **1975**), **revd.** 57 **T.C. 513 (1972)**, cert. denied, 424 U.S. 912 [**47 L.Ed.2d**

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3161 (1976). When faced with a factual situation almost identical to the one presently before us, the court in Madden reversed the tax court's finding that attorneys' fees were currently deductible with this reasoning:

In looking to the origin and character **of** the litigation, however, we are compelled to treat **the** legal expenses as capital in nature. The underlying lawsuit did not arise out of taxpayers' business, but out of the need of a governmental agency **for** taxpayers' land. The public need **presumably** existed without regard to the consequences to taxpayers' business. The government was attempting to appropriate taxpayers' **land and** taxpayers were resisting that attempt.. **Such** a controversy is inherently related to the sale and acquisition of land, even though the ultimate sale, if one is made, is a forced sale. (Citations,)

* * *

[I]n Woodward, the Court noted that "[a] test based upon the taxpayer's 'purpose' in undertaking or defending a particular **piece** of litigation would encourage resort to **formalisms** and artificial distinctions * * *." **397 U.S.** at 577, 90 **S.Ct.** at 1306.

We believe that rejection of the "origin and character", standard in situations such as that in the instant case would result **in** allowing different taxpayers to characterize basically similar litigation in the manner that would have the **most** beneficial tax consequences to each. Although use of the "origin and character", standard allows the governmental agency to determine unilaterally the nature of the litigation, and thus the tax consequences **for**' the taxpayer, we do not think this phenomenon invalidates its application. The agency initiated the **condem-**nation proceedings here for a tax-neutral purpose. Where this is so, there is no 'inherent unfairness to the taxpayer, Furthermore, all taxpayers with capital **assets** affected by the agency's action will be similarly treated. Finally, the element

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of certainty, particularly desirable in tax law, is enhanced.

(Madden v. Commissioner, *supra*, 514 F.2d at 1151~1152.)

We find this reasoning persuasive and adopt the court of appeals' holding. We reach this conclusion despite appellants' argument that the condemnation proceedings were invoked for a reason other than a public purpose. Whether the reason behind the condemnation proceeding was fraud or collusion is not the issue. The fact remains that the proceedings were started **for a** tax-neutral purpose not related to the taxpayers' production of income or their business activities. As such, this case falls squarely under the rationale of Madden.

Appellant's argument that the deductibility of attorneys' fees in a condemnation proceeding turns on the question of whether the condemnation action is for possession of property rather than an action for the taking of title to property misses the point. The Gilmore rationale eliminates the need to distinguish at what point in the litigation, or under what theory! the attorneys' fees change from current expense to **capital** expenditure or vice-versa. (See Woodward v. Commissioner, 397 U.S. 572 (25 **L.Ed. 2d 577**) (1970).) Although separate causes of action based on separate legal theories, separate theories of recovery, and separate stages of litigation may be addressed or reached in a lawsuit challenging a condemnation, all of those **issues and** stages revolve around one central theme, the eminent domain action against the property. It is for that reason the court in Madden found there was no need to **discuss whether attorneys' fees would be deductible if the action was defined as a defense of title or** otherwise. (See Madden v. Commissioner, *supra*, 514 F.2d at 1150, fn. 4.) It is also that focus on the central issue which compels us to reject appellants' suggestion that we allow the deductibility of attorneys' fees in cases where the taxpayer prevails in a condemnation action, but do not allow their deductibility where the taxpayer fails. Such a capricious rule would fly in the **face** of the rationale established in Gilmore, Woodward, and Madden.

Finally, we note that by taking the above position, we reject the line of tax court cases cited **by**

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appellants,^{2/} as those cases were decided prior to the court of appeals' decision in Madden. Since the Madden decision **was** rendered, the tax court itself has specifically rejected its decision in Reakirt v. Commissioner, 29 B.T.A. 1296 (1934), the former leading case in this area and the basis of appellants' argument, and has accepted the propriety of the "origin and character" standard enunciated in Madden as the proper test to determine the deductibility of attorneys' fees in the present context. (See Von Eafften v. Commissioner, 76 T.C. 831 (1981); see also Soelling v. Commissioner, 70 T.C. 1052 (1978); Iske v. Commissioner, ¶ 80,061 T.C.M. (P-H) (1980).)

For the above-stated reasons, respondent's action in this matter will be sustained.

2/ Reakirt v. Commissioner, 29 B.T.A. 1296 (1934); see also Charlie Sturgill Motor Co. v. Commissioner, ¶ 73,281 T.C.M. (P-H) (1973), which was based on the Reakirt rationale as expressed in the tax court case den v. Commissioner, 57 T.C. 513 (1972), prior to the Ninth Circuit's reversal.

